Chapter 5: Employment Issues

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Corrections were made to this workbook through January of 2013. No subsequent modifications were made.

EMPLOYEE OR INDEPENDENT CONTRACTOR

An employer must pay the required amounts of social security and Medicare tax in connection with each **employee's** wages. For 2012, the employer must pay social security taxes of 6.2% of the employee's wages up to a 2012 wage limit of $110,100. The 2011 wage limit was $106,800. In addition, the employer pays Medicare tax at a rate of 1.45%. There is no wage limit on Medicare tax. However, for workers that are properly classified as **independent contractors**, the employer has no obligation to pay these taxes. The independent contractor is responsible for paying all necessary taxes on their own earnings.

RIGHT-TO-CONTROL TEST

A worker is an employee for federal tax purposes if the worker qualifies as an employee under common law.[1] At common law, an employer-employee relationship exists when the firm or person(s) for whom the services are performed has the right to control and direct the worker in how the services are performed.[2] Control over the means and details of the worker's tasks is the hallmark of an employer-employee relationship. It is not necessary for the employer to actually exercise this control. Merely having the **right to control** the worker is sufficient to conclude that the worker is an employee and not an independent contractor.[3]

After reviewing several cases and rulings that used this common law approach, the IRS identified **20 factors** used to determine whether a worker is an employee or an independent contractor. The IRS notes that these factors are only a guide and that the degree of importance of each factor varies depending on the particular circumstances of each case. These factors[4] look into the degree of control that a firm has over the worker across various aspects of a typical work relationship and are summarized as follows.

1. **Degree of control over worker services.** A larger degree of control over when, where, and how the worker performs work is indicative of an employer-employee relationship. Independent contractors have more control over their work.
2. **Training and meetings.** Providing worker training and requiring the worker to attend meetings indicates the existence of an employer-employee relationship.

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1. Rev. Rul. 87-41, 1987-1 CB 296.
2. Ibid.
3. Ibid.
4. Ibid.

3. **Integration of work performed into firm operations.** Strong integration of the worker's services into other firm operations is indicative of an employer-employee relationship.

4. **Personal performance of services.** Employees must personally perform services. The same requirement might not be made of an independent contractor, although there are exceptions. This factor alone is frequently not determinative.

5. **Personnel control.** A firm's control over the hiring, supervision, and payment of the worker's assistants is suggestive of an employer-employee relationship. Independent contractors typically maintain and control their own staff.

6. **Length of working relationship.** A continual, long-term work relationship is indicative of an employer-employee relationship. Such a long-term relationship may also exist with an independent contractor. Therefore, this factor taken alone is not determinative.

7. **Work schedule.** An established work schedule for the worker indicates that an employer-employee relationship exists. Independent contractors generally retain more freedom with scheduling the performance of their services to a firm.

8. **Hours of service required.** Requiring a lengthy period of time from the worker in the performance of services to the firm is indicative of full-time employment within an employer-employee relationship. Conversely, part-time hours worked for one firm while the worker also provides work hours for other firms indicates that the worker may be an independent contractor.

9. **Location of services.** Requiring the worker to perform services at the firm's own location tends to suggest an employer-employee relationship. However, because some types of work can only be performed at the firm's work site, this factor alone is not determinative.

10. **Control over work technique.** Control by the firm over the worker's technique or order of tasks indicates that an employer-employee relationship exists. A worker that has control over the technique or task order in the performance of services indicates that the worker may be an independent contractor.

11. **Periodic reporting.** Requiring regular, periodic written or verbal reports from the worker to other firm personnel is indicative of an employer-employee relationship. However, requiring progress reports by an independent contractor is also common. Therefore, this factor alone is not determinative.

12. **Payment method.** Payment at regular intervals (hourly, weekly, or monthly) suggests an employer-employee relationship. Alternatively, payment to the worker based on the particular job or project, or based on invoices issued by the worker, is indicative of an independent contractor relationship.

13. **Work-related expenses.** Payment of the worker's business and travel expenses suggests an employer-employee relationship. However, this type of arrangement may also exist between a firm and an independent contractor.

14. **Provision of tools.** Tools furnished by the worker indicate that the worker is an independent contractor. A firm that provides the worker with tools suggests the existence of an employer-employee relationship.

15. **Work facilities.** A worker that invests in and provides work facilities is likely to be an independent contractor, particularly if the facilities are of a type not generally maintained by employees.

16. **Profit potential and risk of loss.** Workers that profit from the success of a business and bear the risk of loss from failure are more likely to be independent contractors than employees. Employees are typically paid a fixed amount without regard to profits or losses.

17. **Providing services to multiple firms.** An employee tends to provide services to a single firm. However, an independent contractor frequently provides services to a number of firms.

18. **Restrictions on customers.** Workers who regularly and consistently offer their services to the public are more likely to be independent contractors.

19. **Firm's right of termination.** A firm's ability to terminate the worker for any reason and without penalty suggests an employer-employee relationship. The presence of penalties to the firm upon termination without cause may be indicative of a higher degree of worker independence more characteristic of an independent contractor relationship.

20. **Worker's right of termination.** A worker having the ability to terminate the relationship with the firm at any time without penalty is indicative of an employer-employee relationship.

TAX COURT TEST

To determine whether a worker is an employee or independent contractor, the Tax Court considers the following **seven factors:**[5]

1. The degree of the firm's control over the worker
2. The worker's investment in work facilities
3. Profit or loss potential for the worker
4. The degree of ease with which the firm can discharge the worker
5. The degree of integration of the worker's services to the firm's principal function
6. The temporary or permanent nature of the relationship
7. The parties' understanding of the nature of their relationship

The following example is based on the facts of *Peno Trucking, Inc. v. Comm'r.* [6]

Example 1. PT Trucking owns 15 trucks and leases them to OTC Transport. PT provides OTC with hauling services using these trucks. PT agrees to provide drivers and to ensure that their work is in accordance with the leases. PT obtains drivers to fulfill its obligations to OTC. PT hires, fires, disciplines, and supervises the drivers. PT also determines the days the drivers can work, and requires them to maintain commercial driving licenses, driving logs, and other documents. PT negotiates the rate of pay with each driver, and the contract with each driver indicates that it is not possible for the driver to become indebted to PT in any way. PT provides the necessary equipment for the drivers, although drivers are free to provide extra equipment at their own cost. PT pays for all fuel, tolls, and truck maintenance and repairs.

To provide the hauling services required by the OTC agreement, PT offers drivers the opportunity to accept hauls each day. A driver is free to decline any haul that is offered. However, if the driver accepts, PT provides directions to the driver regarding pick-up and delivery locations as well as times. PT provides drivers with beepers to keep in contact with them on the road. In each driver's contract, PT designates each driver as an independent contractor and issues each driver a Form 1099-MISC in connection with annual pay. PT does not withhold federal taxes, social security, or Medicare taxes.

5. *Herman v. Comm'r*, TC Memo 1986-590 (Dec. 18, 1986).

6. *Peno Trucking, Inc. v. Comm'r,* TC Memo 2007-66 (Mar. 21, 2007).

Example 1 Conclusion. The Tax Court addressed the issue of whether the drivers are independent contractors or employees. In applying the **seven factors,** the Tax Court concluded the following.

PT has a substantial **right to control** the drivers. PT hires, fires, supervises, pays, and disciplines drivers. They also confirm with OTC that the work of the drivers was done properly. PT determines the days the drivers work. PT requires the drivers to have appropriate licenses, logs, and other documents and provides directions to drivers on the hauls. PT is responsible for all truck repairs and maintenance, not the drivers. PT even requires drivers to carry beepers in order to maintain contact with them. This right to control the drivers and the details of their work indicates an employment relationship, not a relationship involving independent contractors.

While drivers **invest** minimal amounts in their own equipment and licenses, PT has made the substantial investment in the trucks and pays for all fuel, oil, tolls, and other expenses. This indicates that the drivers are employees, not independent contractors who would be likely to invest heavily in their own essential equipment.

The drivers are more like employees because they bear **no risk of loss** unlike an independent contractor. In fact, their contract specifically indicates that there is no chance of becoming indebted in the course of performing work for PT. The drivers could only profit from the hauls accepted, without any risk of losing money.

PT has the right to fire drivers, and the drivers can **terminate their relationship** with PT. No facts in this case indicate these termination rights arise from anything other than a legal employer-employee relationship.

Drivers complete hauls, which is precisely the service offered by PT. The drivers' services are therefore **highly integrated** into PT's principal function. This indicates the existence of an employer-employee relationship.

The drivers work consistently for PT and do not have a transitory relationship with PT. This **permanency of relationship** is indicative of an employer-employee relationship.

Lastly, nothing in this case indicates that PT or the drivers **intend** that an independent contractor relationship exists. If a genuine employer-employee relationship exists and the parties describe it as something different, that alternate description is immaterial. Therefore, the PT contracts describing the drivers as independent contractors are irrelevant.

The drivers are employees, not independent contractors.

CLARIFYING WORKER STATUS

Requesting IRS Determination

If the status of the worker is unclear, the worker or the firm can obtain an IRS determination letter resolving this issue.[7] A request is made by filing Form SS-8, *Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding.* The request can be made for determining the status of a single worker or an entire class of workers. There is no fee in connection with this request. Form SS-8 provides details about the nature of the worker's services and the relationship between the worker and the firm. The focal point of several questions involves the degree of control the firm has over the worker's performance of services.

After receiving Form SS-8, the IRS acknowledges its receipt. The determination of worker status for federal tax purposes affects the worker, the firm, and perhaps other parties. The IRS may attempt to obtain further relevant information from all affected parties by sending them a blank Form SS-8 and requesting information. The IRS may also request information from other unaffected parties who can clarify the relationship between the worker(s) and the firm. Information on the first Form SS-8 filed may be shared with other parties.

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7. See Instructions for Form SS-8, *Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding*.

The case is assigned to an IRS technician who reviews the information from the various Forms SS-8 submitted. The technician applies the relevant law and issues a decision on worker status by issuing a **formal determination letter** to the firm. A copy of the determination letter is also forwarded to the worker. The determination letter applies only to the worker or class of workers who are the subject of the request, and the determination is binding on the IRS.

> **Note.** The IRS may issue an **information letter** instead of a determination letter. Unlike the determination letter, an information letter is **not** binding on the IRS. It may be used by the parties to ensure all payroll and income tax obligations are fulfilled.

The IRS will not issue a determination letter in connection with a tax year for which the statute of limitations has expired or in regard to a hypothetical or proposed set of circumstances. The Form SS-8 determination process, including the acquisition of additional information and the review of relevant records, does not constitute an audit of a tax return. This means that appeal rights do not exist with a letter of determination. However, a disagreeing party can request a **redetermination.**

Misclassified Workers

An independent contractor generally receives a Form 1099-MISC, *Miscellaneous Income,* in connection with the services rendered. This amount is typically reported on Schedule C, *Profit or Loss From Business*. Applicable self-employment (SE) tax, calculated using Schedule SE, *Self-Employment Tax,* is paid on the net profit. However, the worker might be treated as an independent contractor by an employer when, in fact, they are an employee.

An employer that has misclassified an employee as an independent contractor has not withheld the employee's share of social security and Medicare taxes nor matched it with the employer's share. The employee uses Form 8919, *Uncollected Social Security and Medicare Tax on Wages,* to calculate their share of these taxes that should have been calculated and paid by the employer. A misclassified employee files Form 8919 if the employee meets one of the following conditions.

1. The worker received correspondence (such as a Form SS-8 determination letter) from the IRS indicating that they are an employee instead of an independent contractor.
2. The worker filed a Form SS-8 but has not yet received an IRS response.
3. The worker was designated as a "section 530 employee" by the employer or IRS before January 1, 1997.
4. The worker was previously treated as an employee by the employer and:
   a. Is presently performing services in a substantially similar capacity under substantially similar direction and control, **or**
   b. Has coworkers performing substantially similar services under substantially similar direction and control who are treated as employees, **and**
   c. Has not yet received an IRS response to a filed Form SS-8.
5. The worker received a Form W-2 and a Form 1099-MISC from the same employer for the same tax year and the Form 1099-MISC amount should have been included as wages on the Form W-2.

Example 2. In 2010, Ignatius worked for KBT Industries, Ltd. as an unskilled laborer in the manufacturing department assembling front-fender kits for automobiles. KBT Industries terminated all 45 employees in the department, including Ignatius, and rehired them on January 1, 2011. However, for 2011, KBT characterized the 45 manufacturing workers as independent contractors. Ignatius performed the same front-fender kit work in 2011 as he did in 2010. He even had the same floor supervisors. Ignatius earned the same amount at KBT in 2011 as he did in 2010.

For 2010, Ignatius received a Form W-2 showing gross wages of $30,000 along with applicable social security, Medicare, and income tax amounts withheld. For 2011, he received a Form 1099-MISC showing $30,000 of gross income with no income tax or payroll tax withholding.

During 2011, Ignatius taught a welding course at a local community college. He received a Form W-2. His gross teaching wages are $17,500.

A tax advisor indicates to Ignatius that he is misclassified as an independent contractor and should file a Form SS-8, which he files in early 2012 after he receives his Form 1099-MISC. No response has yet been received from the IRS. Rather than pay SE tax on his earnings, Ignatius takes the position that he is still an employee at KBT. His tax preparer calculates Ignatius' share of social security and Medicare tax on his earnings for 2011. His tax preparer completes the following Form 8919 for Ignatius, which is filed with his 2011 tax return.

Note. In this chapter, 2011 forms are frequently used rather than draft 2012 IRS forms because many of the draft forms were not available as of the date of publication.

For Example 2

Form **8919**

Department of the Treasury
Internal Revenue Service

Uncollected Social Security and Medicare Tax on Wages

► See instructions on back.
► Attach to your tax return.

OMB No. 1545-0074

2011

Attachment Sequence No. 72

Name of person who must file this form. If married, complete a separate Form 8919 for each spouse who must file this form.

Ignatius Mendoza

Social security number: 012-34-5678

Who must file. You must file Form 8919 if **all** of the following apply.

- You performed services for a firm.
- The firm did not withhold your share of social security and Medicare taxes from your pay.
- Your pay from the firm was not for services as an independent contractor.
- One or more of the reasons listed below under *Reason codes* apply to you.

Reason codes: For each firm listed below, enter in column (c) the applicable reason code(s) for filing this form. If none of the reason codes apply to you, but you believe you should have been treated as an employee, enter reason code G, and file Form SS-8 on or before the date you file your tax return.

A I filed Form SS-8 and received a determination letter stating that I am an employee of this firm.

B I was designated as a "section 530 employee" by my employer or by the IRS prior to January 1, 1997.

C I received other correspondence from the IRS that states I am an employee.

D I was previously treated as an employee by this firm and am performing services in a substantially similar capacity and under substantially similar direction and control. (You must also enter reason code G.)

E My co-workers, performing substantially similar services under substantially similar direction and control, are treated as employees. (You must also enter reason code G.)

F My co-workers, performing substantially similar services under substantially similar direction and control, filed Form SS-8 for this firm and received a determination that they were employees. (You must also enter reason code G.)

G I filed Form SS-8 with the IRS and have not received a reply.

H I received a Form W-2 and a Form 1099-MISC from this firm for 2011. The amount on Form 1099-MISC should have been included as wages on Form W-2.

	(a) Name of firm	(b) Firm's federal identification number (see instructions)	(c) Enter reason code(s) from above	(d) Date IRS determination or correspondence was received (MM/DD/YYYY) (see instructions)	(e) Check if Form 1099-MISC was received	(f) Total wages received with no social security or Medicare tax withholding and not reported on Form W-2
1	KBT Industries, Ltd.	38-0000000	D,G		☑	30,000
2					☐	
3					☐	
4					☐	
5					☐	

6	**Total wages.** Combine lines 1 through 5 in column (f). Enter here and include on Form 1040, line 7; Form 1040NR, line 8; or Form 1040NR-EZ, line 3		6	30,000
7	Maximum amount of wages subject to social security tax	7 106,800 00		
8	Total social security wages and tips (total of boxes 3 and 7 on Form(s) W-2) or railroad retirement (tier 1) compensation, and unreported tips subject to social security tax from Form 4137, line 10	8 17,500		
9	Subtract line 8 from line 7. If line 8 is more than line 7, enter -0- here and on line 10		9	89,300
10	Wages subject to social security tax. Enter the smaller of line 6 or line 9		10	30,000
11	Multiply line 10 by .042 (social security tax rate for 2011)		11	1,260
12	Multiply line 6 by .0145 (Medicare tax rate)		12	435
13	Add lines 11 and 12. Enter here and on Form 1040, line 57; Form 1040NR, line 55; or Form 1040NR-EZ, line 16. (Form 1040-SS and Form 1040-PR filers, see instructions) ►		13	1,695

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 37730B Form **8919** (2011)

IRS ENFORCEMENT

On September 21, 2011, the IRS announced a new voluntary classification settlement program. The program provides substantial relief to employers that voluntarily reclassify workers as employees.

> **Note.** Detailed information on this topic is provided in 2012 Volume C, Chapter 4: Schedule C.

EXCESS SOCIAL SECURITY TAX PAYMENTS

For 2012, the social security wage base is $110,100. Both the employer and employee pay their respective share of social security tax. For 2012, the rate of social security tax that applies on all wages up to the $110,100 wage base is 6.2% for the employer and 4.2% for the employee. No social security tax is payable on wages earned above $110,100. Medicare tax, however, is payable on all wages for the year without any limitation. The maximum amounts of social security tax paid by the employer and employee are as follows.

2012 Maximum Social Security Payment Amounts

	2012 Wage Base		2012 Rate		Maximum Payment
Employer	$110,100	×	6.2%	=	$ 6,826
Employee	110,100	×	4.2%	=	4,624
Total					$11,450

> **Note.** The 4.2% social security rate reflects the "payroll tax holiday" provided to employee taxpayers for 2011, which was extended for 2012. For more information, see 2012 Volume A, Chapter 6: New Legislation.

MULTIPLE EMPLOYERS

When a taxpayer has more than one employer during the tax year and earns a total wage amount in excess of the wage base, a social security tax overpayment can occur. Each employer applies the social security tax rates on the respective wages paid to the taxpayer without regard to what the other employer withheld.

Example 3. Frank is an architect who was an employee at two different jobs during 2012. He worked for Creative Design Associates on a full-time basis. He also accepted a weekend job for part of the year with Modular Building Solutions. Both employers paid their respective 6.2% of social security tax. Each employer also withheld 4.2% for Frank and paid those amounts to the IRS. Frank received a Form W-2 from each employer. The wage amounts and social security tax paid by Frank shown on the Forms W-2 are as follows.

Employer	Wages (Box 1)	Social Security Tax (Box 4)
Creative Design Associates	$ 97,460	$4,093
Modular Building Solutions	36,890	1,549
Total	$134,350	$5,642

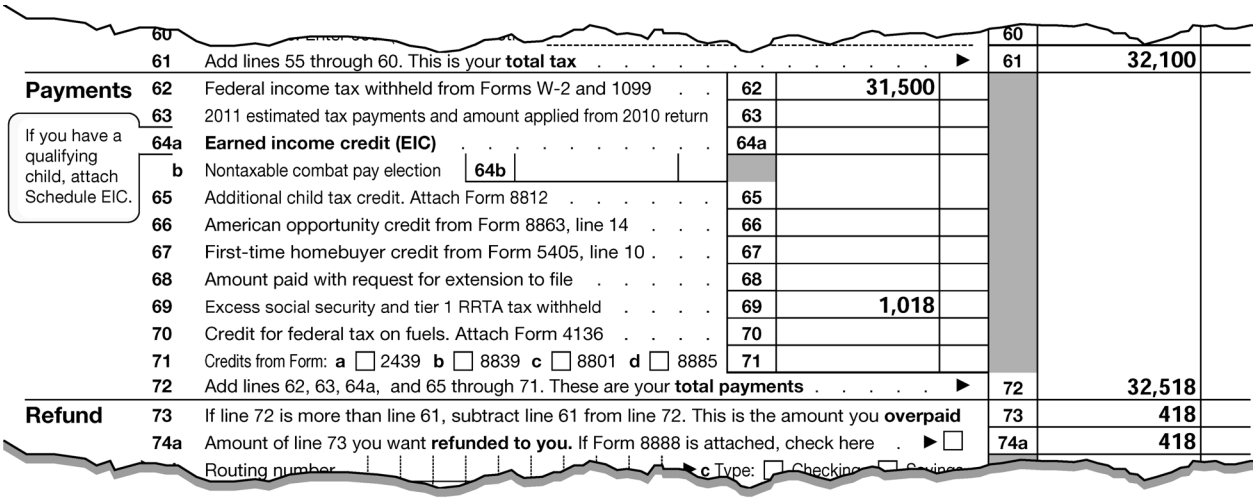
Frank earned a total of $134,350 in wages for the year. However, he is only obligated to pay social security tax on the first $110,100 in 2012. **Therefore, his total 2012 social security tax obligation is $4,624 ($110,100 × 4.2%).** Because he had more than one employer and had earnings in excess of the social security wage base of $110,100, he paid social security tax in excess of the required amount. He overpaid $1,018 ($5,642 actually paid − $4,624 maximum 2012 social security tax).

> **Note.** Although the employee can have the excess FICA withholding refunded, the employers must continue to pay their share.

Recovering the Excess Amount

The excess social security tax paid is calculated and shown on Form 1040, line 69. Before a refund is issued, some or all of the excess is first applied against any income tax owed.

Example 4. Use the same facts as **Example 3.** Frank calculated his $1,018 social security tax overpayment and reported it on Form 1040. His total 2012 income tax liability shown on Form 1040, (total tax) is $32,100. The federal income tax withheld by both employers for 2012 was $31,500. He still owes $600 in federal income tax ($32,100 – $31,500). Therefore, $600 of his $1,018 social security overpayment is used to pay the remaining income tax. Frank receives a refund of the remaining amount of the social security overpayment after deducting the $600 of federal tax owed. The portion of Frank's Form 1040 showing the social security overpayment follows.



	60				60	
	61	Add lines 55 through 60. This is your **total tax** ▶			61	32,100
Payments	62	Federal income tax withheld from Forms W-2 and 1099	62	31,500		
If you have a qualifying child, attach Schedule EIC.	63	2011 estimated tax payments and amount applied from 2010 return	63			
	64a	**Earned income credit (EIC)**	64a			
	b	Nontaxable combat pay election 64b				
	65	Additional child tax credit. Attach Form 8812	65			
	66	American opportunity credit from Form 8863, line 14	66			
	67	First-time homebuyer credit from Form 5405, line 10	67			
	68	Amount paid with request for extension to file	68			
	69	Excess social security and tier 1 RRTA tax withheld	69	1,018		
	70	Credit for federal tax on fuels. Attach Form 4136	70			
	71	Credits from Form: **a** ☐ 2439 **b** ☐ 8839 **c** ☐ 8801 **d** ☐ 8885	71			
	72	Add lines 62, 63, 64a, and 65 through 71. These are your **total payments** ▶			72	32,518
Refund	73	If line 72 is more than line 61, subtract line 61 from line 72. This is the amount you **overpaid**			73	418
	74a	Amount of line 73 you want **refunded to you.** If Form 8888 is attached, check here ▶ ☐			74a	418
		Routing number ▶ **c** Type: ☐ Checking ☐ Savings				

SINGLE EMPLOYER

If the taxpayer works for a single employer and this employer overwithheld an employee's social security tax, the employee first should request that the employer make an appropriate adjustment and refund the overpayment. If the employer refuses to make any adjustment, the employee can still recover the overpayment by filing Form 843, *Claim for Refund and Request for Abatement,* with their tax return.

RECEIPT OF PROPERTY AS COMPENSATION

PROPERTY INSTEAD OF WAGES

If an employee receives property instead of wages in exchange for services, IRC §83(a) specifies that the employee must recognize additional compensation in the amount of the FMV of the property less any amount the employee may have paid for it. The recognition takes place at the time of the transfer and when the property has become **substantially vested** in the employee.

The property is "substantially vested" at the earliest point in time when the employee either:

- Obtains a transferable interest in the property received, or
- Has no substantial risk of forfeiture.[8]

Whether a substantial risk of forfeiture exists depends on the facts and circumstances.[9] A requirement to return the property to the employer if the employee leaves for a competing firm constitutes a substantial risk of forfeiture. Another example of a substantial risk of forfeiture is a requirement to return the property to the employer if earnings are below a specified amount.

STOCK OPTIONS

Stock options are generally rights to purchase a stock at a specified price within a period of time or upon the completion of a vesting period. Stock options provided to employees can either be **nonstatutory** or **statutory.** Each type is treated differently for tax purposes.

Nonstatutory Stock Options

Nonstatutory stock options, sometimes referred to as "nonqualified stock options" (NQSOs), are addressed by IRC §83(a). With a nonstatutory stock option, additional **compensation income** is recognized at the time the option is granted only when the requirements of §83(a) are met and only if the option has a **readily ascertainable** value at the time the option is granted.[10]

If the value of the option is not readily ascertainable at the time of the grant, income is recognized at the time the option is **exercised** or **sold.**[11] Although it is possible for a nonmarket traded option to have a readily ascertainable value,[12] as a practical matter, most small business options do not have a value that can be ascertained at the time of grant. These options therefore do not trigger income until **exercised.**

> **Note.** The taxpayer receiving a nonstatutory stock option without a readily ascertainable value has no taxable event until the option is exercised. However, a special tax election is available under IRC §83(b) to report the additional compensation income in the year the option is granted. This election is available for stock options and any other property received that is covered by §83(a). The election is generally irrevocable.[13]

8. IRC §83(a).
9. Treas. Reg. §1.83-3(c).
10. Treas. Reg. §1.83-7(a).
11. Ibid.
12. Treas. Reg. §1.83-7(b).
13. See Treas. Reg. §1.83-2.

Example 5. Bob is employed by Monday Morning, Inc. (MMI). MMI is a publicly listed company. In 2011, MMI grants Bob an option to purchase 100 MMI shares of stock at an exercise price of $40 per share when MMI stock has an FMV of $100 per share. The option is valued at $6,120 at the time of the grant to Bob. Bob paid $500 for the option.

Bob exercises the option in January 2012, when the market value of MMI shares is still $100 per share. He buys 100 shares of stock with an FMV of $10,000 and pays the option exercise price of $4,000 ($40 × 100 shares).

Because the value of this option is readily ascertainable at the time of the grant, it is considered additional compensation to Bob at the time it is granted. Bob must report the FMV of the option at the time it is granted less the amount he paid for it. Bob therefore has additional 2011 compensation income of $5,620 ($6,120 option FMV – $500 paid for the option). Bob's exercise of the option in 2012 is not taxable. His basis in the stock is calculated as follows.

Amount paid for the stock	$4,000
Amount of additional 2011 compensation reported	5,620
Total stock basis	$9,620

Observation. Employers providing stock options to employees generally use software to calculate the FMV of the option. This involves complex calculations using option valuation models.

Example 6. On January 3, 2011, Myra receives a nonqualified stock option from her employer, Smalltown Metal Fabricating, Inc. Smalltown is a family-owned business that is not publicly listed. Myra's stock option provides her with the right to purchase 100 shares of Smalltown common stock at an exercise price of $20. Myra exercises her option on July 12, 2012. On that date, it is established that Smalltown common shares have an FMV of $35 per share.

Because the nonqualified option does not have a readily ascertainable value on the January 3, 2011 grant date, the grant is a nontaxable event. However, Myra has additional compensation income to report in 2012 when she exercises her option. Her additional compensation is $1,500 (($35 FMV – $20 exercise price) × 100 shares).

Example 7. Use the same facts as **Example 6.** However, after Myra exercises the option on July 12, 2012, she sells her 100 Smalltown shares on July 15, 2012. Through a broker, she finds a buyer who pays her $40 per share. The broker's commission is $40.

Myra has the same additional compensation income of $1,500 in 2012 as explained in **Example 6.**

The details of Myra's 2012 short-term capital gain on the sale of 100 shares is shown below.

Basis in shares	
Amount paid upon option exercise	$2,000
Amount of additional 2012 compensation reported	1,500
Total basis	$3,500
Capital gain on sale of shares	
Proceeds from the sale of shares ($40 per share × 100 shares)	$4,000
Less: basis	(3,500)
Less: broker commission	(40)
Capital gain (short-term)	$ 460

The $460 capital gain recognized by Myra in 2012 is a short-term capital gain because she held the shares for less than one year.

Example 8. Use the same facts as **Example 7,** except Myra holds the shares for over one year and sells them in September 2013. Myra has $1,500 in additional compensation in 2012 upon exercising her option. She also recognizes a $460 capital gain. However, this is a **long-term** capital gain because her holding period was greater than one year. The long-term gain is recognized in the 2013 taxation year.

W-2 Reporting. The difference between the FMV of the shares and the option exercise price is called the "spread." When an employee exercises a nonstatutory stock option, the employer generally includes the spread as additional compensation.[14] This compensation is subject to social security, Medicare, and federal unemployment taxes at the time the option is exercised. The employer is required to withhold the appropriate taxes on the spread amount.

On the employee's Form W-2, the spread amount is added to other compensation for the year in box 1 and is also included in boxes 3 and 5. The amount of the spread also is reported in box 12 with code "V" to indicate the nature of the amount.

Statutory Stock Options

Statutory stock options, often called incentive stock options (ISOs), are governed by IRC §§421 and 422. These stock options are called "statutory" because the two Code sections provide additional tax advantages to the special stock options that are not associated with nonstatutory stock options. The following requirements must be met for a stock option to be statutory.

- The taxpayer must be employed by the company granting the option at the time the option is granted.
- The taxpayer must remain an employee of the company continuously throughout the option period until at least three months before the option is actually exercised.
- The option granted must be nontransferable, except upon the taxpayer's death.[15]

Employment with a parent or subsidiary of the company granting the option also meets these requirements.[16] If these requirements are not met, the option is treated as nonstatutory.

A taxpayer receiving a statutory stock option does not report income either when the option is granted or when it is exercised.[17] The option holder acquires stock by exercising the option. The subsequent sale of that stock is a taxable event. Capital gains tax treatment applies to the share sale if the taxpayer holds the shares at least:

- One year after they are purchased upon exercise of the option, and
- Two years after the date the option was granted.

Selling the stock before meeting these holding period requirements results in a **disqualifying disposition.** This triggers additional **compensation income.** However, compensation income from a disqualifying disposition, although included in box 1 of Form W-2, is not subject to payroll taxes.

> **Note.** Many large publicly traded companies provide ISO plans for their employees. See pages 208–213 in the 2011 *University of Illinois Federal Tax Workbook* for more information regarding the proper tax treatment for ISOs that are exercised.

14. Treas. Reg. §1.83-7.
15. IRC §422(a)(2).
16. Ibid.
17. IRC §421(a)(1).

PAYMENT-IN-KIND WAGES

Farmers and ranchers have rules that may allow them to pay some employees in kind (livestock or grain) rather than in cash. These are called payment-in-kind (PIK) wages. The rules are very specific and the employer must adhere to them explicitly. The **advantage** of PIK wages is there is no social security or Medicare withholding or matching by the employer. The **disadvantage** is that the employee receives no credit for social security or Medicare. In addition, the PIK wages are not treated as SE income on the employee's Form 1040.

> **Note**. A detailed discussion of PIK wages can be found in the 2002 *University of Illinois Federal Tax Workbook* beginning on page 195. This can be accessed at **www.TaxSchool.illinois.edu/taxbookarchive.**

LEGAL EXPENSES

BASIC RULES

Legal fees associated with personal matters are **not deductible.**[18] In addition, legal fees related to the acquisition or disposition of a capital asset are not deductible. Instead, they are capitalized. This includes legal fees incurred to perfect a title, recover property, or to develop or improve property.[19]

Legal fees associated with an income-producing activity or to establish or protect a source of **taxable** income for the taxpayer are **generally deductible.**[20] This includes legal fees associated with performing or maintaining a job either as an employee or as a self-employed worker.[21] Although legal fees associated with the acquisition or recovery of capital assets are not deductible, legal costs associated with the recovery of investment property or income from property are deductible.[22] In order for the legal costs to be deductible, they must be "ordinary and necessary." This means the legal fees must bear a close relationship to the production of income and must be reasonable.[23]

TWO-FACTOR TEST

To determine whether legal fees are personal or whether there is a sufficient relationship between the legal fees and an income-producing activity of the taxpayer, two factors are considered.

1. The **origin of the claim**
2. The **character of the controversy**

Deductible legal fees in connection with employment are claimed as a miscellaneous itemized deduction on Schedule A, line 23, and are subject to the 2% threshold.

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18. IRC §262.
19. Treas. Reg. §1.212-1(k).
20. IRC §212.
21. See IRS Pub. 529, *Miscellaneous Deductions*.
22. Treas. Reg. §1.212-1(k).
23. Treas. Reg. §1.212-1(d).

Example 9. Graham is the regional vice president of sales for Muddy River Software (MRS). On a weekend, Graham was driving home from a friend's party and was involved in an automobile accident. Graham's blood alcohol level was beyond the legal limit. He was arrested for drunk driving. He incurred legal fees to defend his subsequent criminal charge for driving under the influence of alcohol.

Graham's legal fees are not tax deductible. The origin and character of the controversy are **personal.** The claim arose from an incident arising on Graham's personal time while traveling from a personal event having nothing to do with his business or employment.

Example 10. Use the same facts as **Example 9.** Before Graham's trial date pertaining to his DUI charge, MRS suspends Graham without pay because of the criminal charges against him.

Graham hires a lawyer to sue MRS for back pay and reinstatement. The origin and character of this claim involves Graham's employment and the recovery of income from his employment. The legal fees in connection with Graham's case against MRS are deductible as a 2% miscellaneous itemized deduction.

Example 11. Lloyd is self-employed and is the proprietor of Double L Property Management. Lloyd owns, rents, and maintains several residential and commercial properties.

Lloyd embezzles money from a client's account into which rent checks from tenants are deposited. After a criminal trial and conviction for embezzlement, the government moves to attach and seize rental properties owned by Lloyd to enforce restitution measures.

Lloyd hires a lawyer to defend him from the government's attempt to seize his properties. The defense against the seizure arises from the embezzlement case, which involved a **personal act.** Despite the fact that the property being seized is income-producing, the **origin and character** of the embezzlement claim is **personal.** Lloyd cannot deduct the legal fees incurred in defending his interest in the rental properties he owns.

Divisibility

Legal fees that involve both personal matters (for which the legal fees are not deductible) and business, employment, or income-related matters (for which the legal fees may be deductible), can be divided into deductible and nondeductible amounts. However, legal fees in connection with income that is tax-exempt are nondeductible.

Example 12. During 2012, Ornella incurred legal fees of $5,000 to establish her social security disability (SSD) benefit. Ornella is successful and receives $10,000 in SSD benefits in 2012. Only 40% of her SSD benefit is taxable in 2012. Because only 40% of her SSD benefit is taxable, she can deduct only 40%, or $2,000 (40% × $5,000) of her legal fees in connection with her SSD case.

LEGAL AWARDS AND SETTLEMENTS

BASIC RULE

Gross income is broadly defined to include all income from whatever source derived[24] and includes the amount of any legal award or settlement unless some specific exception exists. Amounts awarded to employees for back pay under a court order or order of the National Labor Relations Board are considered wages and are subject to payroll tax withholding.[25] The amounts awarded are subject to federal payroll tax withholding at the rates in effect at the time the payments are made, not when originally earned.[26] Interest on back pay awards is not considered wages if it is separately identified.[27]

PERSONAL INJURY OR SICKNESS EXCEPTIONS

IRC §104 provides several exceptions to the basic income inclusion rule for legal awards received for injury or sickness. The exception rules do not apply to the extent that related medical expenses have been deducted in prior tax years.[28]

Damage Awards

Personal injury or sickness damage awards are specifically **excluded** from gross income.[29] However, any **punitive damages**[30] or **prejudgment interest**[31] received along with such an award are included in income. Punitive damages are reported on **Form 1040, line 21,** as "other income."

Workers' Compensation Benefits

Amounts received from a statutory workers' compensation arrangement that provides benefits to employees for personal injuries or sickness are excluded from gross income.[32] This income exclusion also applies to such payments made to survivors of a deceased employee.[33] However, the income exclusion does not apply to benefits that:

- Constitute a retirement pension or annuity determined by the employee's contributions or length of service,
- Are received in connection with a nonoccupational injury or sickness, or
- Are in excess of the amount provided for under the statutory workers' compensation arrangement.[34]

Note. For a case illustrating this issue, see *Sewards v. Comm'r* in 2012 Volume B, Chapter 6: Rulings and Cases.

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24. IRC §61.
25. *Social Security Board v. J. Neirotko,* 327 U.S. 358 (1946); Rev. Rul. 78-336, 1978-2 CB 255; Rev. Rul. 57-55, 1957-1 CB 304; Rev. Rul. 75-64, 1975-1 CB 16.
26. Rev. Rul. 78-336, 1978-2 CB 255.
27. *G.J. Hemelt v. U.S.,* 122 F.3d 204 (4th Cir. 1997).
28. Treas. Reg. §1.104-1(a).
29. IRC §104(a)(2); Treas. Reg. §1.104-1(c).
30. Ibid.
31. *C.A. Chamberlain v. U.S.*, 286 F.Supp.2d 764 (E.D.La. 2003).
32. IRC §104(a)(1); Treas. Reg. §1.104-1(b).
33. Treas. Reg. §1.104-1(b).
34. Ibid.

Accident or Health Insurance

An employer's cost of providing healthcare coverage to employees is excluded from the employees' income.[35] Accident or health insurance benefits or proceeds are included in the taxpayer's gross income[36] if:

- The taxpayer's employer paid the premiums,
- Those premiums were not included in the taxpayer's income,[37] **and**
- The amounts are not excludable as either a **reimbursement** for medical care[38] or payment **unrelated to work absence.**[39]

Amounts paid to **reimburse** the taxpayer for expenses incurred for the medical care of the taxpayer, taxpayer's spouse, or dependent are excludable.[40] "Dependent" includes any child of the taxpayer who has not attained age 27 at the end of the tax year.

> **Note.** The Patient Protection and Affordable Care Act[41] extended these exclusionary rules to any child of the taxpayer who has not attained 27 at the end of the tax year.[42] This provision is effective as of September 23, 2010.

In order to be excludable, a payment **unrelated to work absence** must:

- Compensate the taxpayer for permanent disfigurement, or total loss or loss of the use of a body part or bodily function of the taxpayer, spouse, or a dependent,[43] and
- Be computed based on the nature of the injury without regard to work absence.

Example 13. Sarita's employer, Diversified Engineering, pays 100% of her healthcare coverage. The premiums are not included in Sarita's income. Part of the healthcare coverage is an accidental death and dismemberment (AD&D) policy, which specifies the payment of various lump sum amounts in connection with the loss or loss of use of various parts of the body or bodily function.

Sarita was supervising the machining of a custom engine part. The fracture of a large drill bit caused severe injury to Sarita's left eye. Sarita lost the use of her eye. She received $6,200 of healthcare benefits under her employer-paid coverage. The $6,200 benefit does not constitute a reimbursement for expenses. In addition, her AD&D coverage specified that it would pay $10,000 for the loss of an eye. Sarita received the $10,000 AD&D payment. Although the $6,200 of health insurance benefits is included in Sarita's income under IRC §105(a), the $10,000 AD&D payment is unrelated to work absence. It is **excludable** under §105(c).

Example 14. Use the same facts as **Example 13,** except Sarita's eye injury occurred at home while she was making muffins using a faulty blender. Her AD&D coverage pays $10,000 for the loss of a body part or bodily function. The $10,000 is still excludable under §105(c).

> **Note.** A particular AD&D policy may cover only work-related injuries or it may cover injuries occurring anywhere. However, the location where the injury occurred is not relevant for purposes of obtaining the income exclusion of an AD&D payment under §105(c).

35. IRC §106(a).
36. IRC §105(a).
37. Treas. Reg. §1.105-1(a).
38. IRC §105(b).
39. IRC §105(c).
40. Treas. Reg. §1.105-2.
41. PL 111-148 (Mar. 23, 2010).
42. IRC §162(l)(1)(D).
43. IRC §105(c)(1).

Example 15. Use the same facts as **Example 13,** except that the AD&D policy was not structured to pay a lump sum. Instead, the policy specified that it would pay $1,000 per week during an injury-related work absence up to a maximum of 10 weeks. Sarita missed more than 10 weeks of work and received the maximum $10,000 benefit. Under §105(c)(2), the $10,000 AD&D benefit is included in Sarita's income because it is based on work absence and not on the nature of the injury.

Prorating Costs of Individual and Group Policies. When the employer and taxpayer each pay for part of the premium of an **individual policy,** the benefit amount is divided into includable and excludable portions.

Example 16. Manfred works for AGT Industries (AGT). He has health insurance coverage through his employer. In 2012, Manfred pays 40% of his annual premium and AGT pays the remaining 60%.

During 2012, Manfred receives $10,000 of benefits from this coverage as reimbursement for the surgical and hospitalization costs he incurred during the year. Because Manfred pays 40% of the premium, 40% of the insurance benefits, or $4,000 (40% × $10,000), is attributable to the portion of the annual premium he paid. This $4,000 is excludable under IRC §104(a)(3) to the extent that Manfred has not deducted any of the amount as medical expenses.

The remaining 60% of the benefits, or $6,000, is the amount attributable to the premium paid by the employer. This amount is subject to IRC §105(a). Because Manfred received this amount as a reimbursement for incurred medical costs, the amount is excludable by Manfred under §105(b).[44]

Special rules exist for prorating the cost of **group policies.** At the beginning of the calendar year, if the respective premium payment amounts for both the employer and employees are known for at least three full policy years, the premiums are averaged to arrive at the percentage of benefits attributable to the employee's premiums. This is the percentage of benefits that are excludable. The remaining amount of benefits attributable to the employer's premiums is included in income when received by the employee.

Example 17. In 2012, Branford receives $10,000 of health insurance benefits from the coverage provided by a **group plan** through his employer. Branford received this $10,000 benefit as a reimbursement for 2012 medical expenses that he incurred.

With this group plan, the employees and the employer each pay a portion of the cost of the coverage. Branford needs to know how much of his benefits are attributable to the employer-paid premiums because this determines the portion of the benefit that he must include in income for the year.

On January 1, 2012, the information for total premiums, employer's share, and employees' share is not yet known because there are adjustments for dividends and discounts that the insurer must calculate that are not available until the following March. However, such data does exist for 2008, 2009, and 2010, as follows.

Policy Year	Total Annual Net Premium	Employer Share of Net Premium
2008	$20,000	$12,000
2009	23,000	8,000
2010	17,000	10,000
Total	$60,000	$30,000

Accordingly, data from 2008, 2009, and 2010 are used to calculate the percentage of the health benefits Branford must include in 2012 income. To calculate this percentage, the following formula is used.

44. Treas. Reg. §1.105-1(d)(1).

$$\text{Percentage of health benefits} = \left(\frac{\text{Employer share of net premiums for three years}}{\text{Total net premiums for three years}}\right) \times \text{Health benefits received}$$

$$= \left(\frac{\$30{,}000}{\$60{,}000}\right) \times \$10{,}000$$

$$= \$5{,}000$$

Consequently, 50%, or $5,000, of Branford's $10,000 health benefit is attributable to the **employer's share** of the premiums and is excludable under §105. Because the benefits received served to reimburse Branford for costs incurred during the year, this 50% is excludable by Branford under §105(b). The other 50% of the benefits is attributable to the amount of premiums paid by Branford and is excludable from income under §104(a)(3) to the extent Branford has not deducted them as medical expenses on his return.[45]

Note. CCA 20122037, issued on May 1, 2012, states that all Medicare premiums paid for the taxpayer, spouse, and children up to age 27 can be deducted.

If the employer's share of premiums and total premium amounts for three full policy years are not known, then it is acceptable to use such amounts covering at least **one** policy year. When figures for one policy year are not known, then the current year's net premium amounts or a reasonable estimate of the current year's premiums are used.[46]

Self-Employed Taxpayers. Self-employed taxpayers can deduct all of their healthcare policy premiums paid during the year up to the amount of net earned SE income.[47] A deduction can be claimed for the cost incurred for accident and health insurance for the taxpayer, taxpayer's spouse, dependents, and any child of the taxpayer who has not attained age 27 by the end of the tax year. Self-employed taxpayers that can claim the self-employed health insurance deduction include the following.

- Self-employed taxpayers reporting income on Schedules C or F
- General partners in a partnership
- Actively participating members in an LLC that has elected partnership tax treatment
- Employees of an S corporation who own 2% or more of the corporation's stock

Note. While it appears that a self-employed individual can deduct Medicare Part B premiums, guidance is unclear on whether other Medicare premiums may be deducted.

This deduction directly reduces adjusted gross income rather than being treated as an itemized deduction. However, with an exception for the 2010 tax year,[48] this deduction cannot be used to reduce net earned income for purposes of calculating the applicable SE tax for the year. Moreover, this deduction is not available for any month in which the self-employed person is eligible to participate in a subsidized health plan of their employer or spouse's employer.[49]

For purposes of the employees' income exclusion for accident or health insurance benefits or proceeds, self-employed taxpayers are specifically excluded from the definition of "employee."[50] However, the same exclusion is available to self-employed taxpayers if the accident or health benefits are paid under an insurance contract or similar arrangement.[51]

45. Treas. Reg. §1.105-1(d)(2).
46. Ibid.
47. IRC §162(l)(2)(A).
48. IRC §162(l)(4), as amended by the Small Business Jobs Act of 2010, PL 111-240 (Sep. 27, 2010).
49. IRC §162(l)(2)(B).
50. IRC §105(g); Treas. Reg. §1.105-5(b); Treas. Reg; §1.105-1(a).
51. Treas. Reg. §1.72-15(g).

MOVING EXPENSES

A taxpayer may deduct moving expenses in connection with the "commencement of work" in a new principal place of work as either an employee or as a self-employed individual.[52]

Commencement of work includes the following.[53]

- The beginning of employment or self-employment for the first time
- The beginning of full-time employment or self-employment after a substantial period of part-time employment or unemployment
- Beginning employment with a different employer
- Beginning work for the same employer in a new location
- Engaging in a new SE trade or business
- Engaging in self-employment at a new location

Moving expenses include only the following reasonable expenses.

- Moving household goods and personal items from the old residence to the new residence[54]
- Traveling between the old and new residences (including any lodging)

In order to be deductible, **all** of the following must apply.

- The moving expenses must be incurred within one year of the actual move, unless there is good cause for expenses beyond one year.[55]
- The taxpayer's commute from their former home to the new work location is at least 35 miles longer than the commute to the former workplace.[56]
- The taxpayer is employed full-time for at least 39 weeks in the year immediately following the move.
- The taxpayer is self-employed full-time for at least 78 weeks in the 2-year period following the move with at least 39 of those weeks within the first year.[57]

> **Note.** Additional rules associated with the deduction of moving expenses are found in Treas. Reg. §1.217-2.

52. IRC §217(a).
53. Treas. Reg. §1.217-2(a)(3).
54. IRC §217(b)(1).
55. IRC §217(c).
56. Ibid.
57. Treas. Reg. §1.217-2(c)(4).

TAXATION OF FRINGE BENEFITS

Fringe benefits are taxable to the worker unless a specific exclusion from income exists. As a general rule, the FMV of the entire amount of the fringe benefit must be included, less the following.

- The amount for which there is a specific exclusion
- The amount, if any, that the worker paid for the fringe benefit

Fringe benefits not specifically excluded from income are subject to payroll taxes.[58]

The following forms are used to report the taxable value of fringe benefits received by various workers.

Worker	Form
Employee	Form W-2
Partner	Schedule K-1 (for Form 1065)
Independent contractor	Form 1099-MISC

Note. Additional information on the tax treatment of various fringe benefits can be found in IRS Pub. 15-B, *Employer's Tax Guide to Fringe Benefits;* IRS Pub. 525, *Taxable and Nontaxable Income;* and the Taxable Fringe Benefits Guide available at **www.irs.gov/pub/irs-tege/fringe_benefit_fslg.pdf.**

STATUTORY FRINGE BENEFITS

Specific statutory exclusions exist for the following fringe benefits, which are called "statutory fringe benefits."

Statutory Fringe Benefit	Tax Code Section Providing Income Exclusion
No-additional-cost services	§132(b)
Employee discounts	§132(c)
Working condition fringe benefits	§132(d)
De minimis fringe benefits	§132(e)
Qualified moving expense reimbursements	§132(g)
Qualified retirement planning services	§132(m)
Qualified transportation	§132(f)

These statutory fringe benefits, when provided by an employer to an employee, are excludable from gross income and are not subject to payroll taxes.

Definition of Employee

An "employee" is an individual employed by the employer. However, the definition of employee is expanded for some of the above statutory fringe benefits. For specific guidance on who is considered an employee for purposes of the above statutory fringe benefits, see Treas. Reg. §1.132-1(b).

58. U.S. House of Representatives, Ways and Means Committee, Committee Report on Tax Reform Act of 1984. (H. Rept. 98-432), Washington: Government Branch Office, 1984.

No-Additional-Cost Services

A "no-additional-cost service" is a fringe benefit provided to all employees under the following circumstances.

- The service provided to employees is the same service that the employer provides to its general business customers.
- The employer does not lose revenue or incur a substantial cost in providing the service to employees.[59]

If the above conditions are met, the value of the fringe benefit is not included in the employee's income.[60] A no-additional-cost fringe benefit is typically a benefit provided to employees from the employer's excess capacity.[61]

Example 18. FlyByNight Airlines Corp. provides its employees with the ability to travel from airport to airport by using unsold seats. These seats are part of FlyByNight's excess capacity and FlyByNight does not lose revenue or incur substantial additional cost by providing them to employees. The airline seats provided to employees are a tax-free no-additional-cost benefit.

Nondiscrimination. Highly compensated employees receiving a no-additional-cost benefit cannot exclude the benefit from their income unless that benefit is made available on substantially the same terms to either:

- All employees of the employer, or
- A group of employees of the employer defined in a nondiscriminatory manner.

> **Note**. There are several details regarding the nondiscrimination rules applicable to certain fringe benefits. These details are outlined in Treas. Reg. §1.132-8.

Employee Discounts

A "qualified employee discount" is a discount provided to employees in connection with "qualified property or services" that is excludable from the employee's gross income. Employee discount fringe benefits are also subject to the **nondiscrimination** requirements mentioned in the last section.

Qualified property or services are any property or services that the employer offers to its customers in the ordinary course of business in which the employee performs substantial services.[62] Real property and personal property commonly held for investment, such as commodities, securities, or currency, are specifically excluded from the definition of qualified property.[63] Property or services that are only offered to employees at an employee store or in an employee catalogue do not qualify.[64]

A **qualified employee discount** for qualified **property** is an employee discount that does not exceed the employer's aggregate gross profit percentage (AGPP) multiplied by the property's normal price to customers.[65]

AGPP is calculated as follows.

$$\text{AGPP} = \frac{\text{Aggregate sales price} - \text{Aggregate cost}}{\text{Aggregate sales price}}$$

59. IRC §132(a)(1) and Treas. Reg. §1.132-2(a).
60. Ibid.
61. Treas. Reg. §1.132-2(a)(2).
62. Treas. Reg. §1.132-3(a)(2)(i).
63. Treas. Reg. §1.132-3(a)(2)(ii).
64. Treas. Reg. §1.132-3(a)(2)(iii).
65. Treas. Reg. §1.132-3(a)(1)(i).

Example 19. Bargain Bob's retail computer outlet has merchandise with a total cost of $100,000 and a total sales price of $130,000. Bargain Bob's recently gave an employee, Myron, a $400 discount on a laptop that has a sales price of $1,000. The amount of excludable employee discount is calculated as follows.

$$\text{Bob's AGPP} = \frac{\text{Aggregate sales price} - \text{Aggregate cost}}{\text{Aggregate sales price}}$$
$$= \frac{\$130{,}000 - \$100{,}000}{\$130{,}000}$$
$$= 23.08\%$$

$$\text{Amount of excludable employee discount} = \text{AGPP} \times \text{Normal sales price}$$
$$= 23.08\% \times \$1{,}000$$
$$= \$231$$

Therefore, of Myron's total $400 employee discount, **$231 is excludable from his income.** The remaining **$169 ($400 – $231) must be included in Myron's income** and is taxable to him in the year the discount was provided.

A **qualified employee discount** for qualified **services** is an employee discount that does not exceed 20% of the service's normal price to customers.[66]

Example 20. Use the same facts as **Example 19,** except Bargain Bob's also gives Myron an employee discount on software installation. Bargain Bob's charges customers $100 for this service. Myron was only charged $30. The amount of excludable discount is $20 (20% × $100). Of Myron's $70 discount, $20 is excludable from income and the remaining $50 is taxable.

Note. Additional rules in connection with employee discounts can be found in Treas. Reg. §1.132-3.

Working Condition Fringe Benefits

A working condition fringe benefit is any property or service provided to an employee that the employee could deduct under IRC §162 or §167 if the employee paid for the property or service. The §162 or §167 deduction that the employee could have taken must be related to employment provided by the employer rather than another trade or business the employee may have.[67] Gross income does not include a working condition fringe benefit.[68] Deductibility under Code sections other than §§162 and 167 does not give rise to a working condition fringe benefit.[69]

Note. IRC §162 provides a deduction for ordinary and necessary expenses to carry on a trade or business. IRC §167 allows a depreciation deduction for property used in a trade or business or property held for the production of income. In addition, IRC §274(d) and related regulations require substantiation for some of these deductions. Any §274(d) substantiation requirement necessary under §162 or §167 is also necessary for a working condition fringe benefit under these Code sections.

66. Treas. Reg. §1.132-3(a)(1)(ii).
67. Treas. Reg. §1.132-3(a)(2)(i).
68. Treas. Reg. §1.132-5(a)(1).
69. Treas. Reg. §1.132-5(a)(1)(iii).

Example 21. Walter works as a financial planner for Northern Capital Planners (NCP). NCP pays for Walter's annual subscriptions to various financial planning periodicals as well as for subscriptions to *The Wall Street Journal* and *The Financial Times*. NCP also pays Walter's professional dues required for his state mutual fund sales license. The cost of the subscriptions and the amount of Walter's dues paid by NCP are working condition fringe benefits. If Walter paid for these items directly, he would be entitled to deduct them as business or trade expenses under §162.

Cash payments to employees qualify as a working condition fringe benefit only if the employee is required to do all of the following.

- Spend the cash payment in accordance with a specific or prearranged event or activity that would give rise to an allowable deduction under §162
- Verify that the payment has in fact been used for such an event or activity
- Return any part of the payment that was not used to the employer[70]

De Minimis Fringe Benefits

A de minimis fringe benefit is any property or service provided to the employee that has such a small value that accounting for it is unreasonable or impractical.[71] Examples of de minimis benefits include the following.

- Occasional typing of personal letters by a company secretary
- Occasional parties or group meals for employees or their guests
- Birthday or holiday gifts of low value
- Occasional sporting event or theater tickets
- Flowers, fruit, or books provided to employees for special circumstances

The value of the benefit and the **frequency** with which it is provided to the employee are considered in determining whether the benefit is de minimis. Frequency must be considered on an individual employee basis. If the fringe benefit is too valuable or frequent to be excluded, then the entire value is included in gross income.

Example 22. Katie is one of 78 administrative employees of HGT Plastics, Inc. (HGT). HGT provides all 78 administrative employees with a simple dinner for Thanksgiving and Christmas holidays. The meals constitute a de minimis fringe benefit for each of the 78 employees.

Example 23. Use the same facts as **Example 22,** except Katie also receives an employer-provided meal twice weekly in addition to having the Thanksgiving and Christmas meals with the other 77 administrative employees. All of Katie's meals, including those given for Thanksgiving and Christmas, constitute a taxable fringe benefit to her. Because the other 77 employees only receive the holiday meals, the benefit is de minimis for them.

Items that **do not** constitute de minimis fringe benefits include the following.

- Season tickets for sporting events or theater productions
- Use of an employer-provided vehicle to commute more than once per month
- Country club or athletic facility membership
- Use of employer facilities for a weekend or vacation
- Cash or credit card use

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70. Treas. Reg. §1.132-5(a)(5).

71. IRC §132(e)(1).

Qualified Moving Expense Reimbursements

A qualified moving expense reimbursement is any amount received by the employee from the employer for moving expenses that would be deductible as a moving expense by the employee under IRC §217 if the employee directly paid for the expenses.

> **Note.** The general rules regarding moving expenses are found earlier in this chapter.

Employer moving expense reimbursements are subject to the same substantiation requirements as an employee reimbursement plan. These requirements were discussed earlier in this chapter.

Qualified Retirement Planning Services

Employer-provided financial counseling services are a taxable benefit to the employee[72] unless the services are excludable **qualified retirement planning services**. "Qualified retirement planning services" consist of any retirement planning information and advice provided by an employer maintaining a qualified retirement plan. Qualified retirement plans include the following.

- Qualified pension plans under IRC §401(a)
- Qualified annuity plans under IRC §403(a)
- Governmental plans
- IRC §403(b) accounts
- SEP and SIMPLE IRAs

> **Note.** IRC §457 deferred compensation plans, available to certain state and local government employees, are **not** considered qualified retirement plans.

The exclusion applies to qualified retirement planning services provided to the employee and the employee's spouse. The exclusion does not apply to related services such as tax preparation, accounting, legal, or brokerage services.[73]

Qualified Transportation

Employer-provided **qualified transportation benefits** are excludable from the employee's income. Specifically, "qualified transportation benefits" and the inflation-adjusted maximum monthly exclusion for the 2012 tax year are as follows.

Qualified Transportation Benefit	2012 Maximum Monthly Exclusion
Van pooling	$125
Transit passes	125
Qualified parking	240
Qualified bicycle commuting reimbursement	20

This exclusion covers employer-provided transportation and cash reimbursements.[74] Cash advances, however, are not covered by this exclusion.[75]

72. Ltr. Rul. 199929043 (Apr. 22, 1999).

73. Conference Committee Report to PL 107-16 (2001), H.R. Conf. Rep. No. 107-84.

74. IRC §132(f)(3).

75. Treas. Reg. §1.132-9(b).

Athough the employer can simultaneously provide the employee with any combination of the first three benefits listed above,[76] a bicycle commuting reimbursement benefit cannot be provided to the employee during a month when any of the other three are received.[77]

Employers that make cash reimbursements must have a reimbursement arrangement in place to substantiate that their employees have in fact incurred costs associated with vanpooling, transit passes, or qualified parking. The existence of a reimbursement arrangement is based on a facts and circumstances analysis.[78] An employer distributing transit passes to employees has no substantiation requirements.

OTHER FRINGE BENEFITS

In addition to the statutory fringe benefits discussed previously, there are a number of other fringe benefits that may be available to employees. Some of these are as follows.

Dependent Care Assistance

A taxpayer may qualify for a tax credit for household or dependent care expenses that the taxpayer incurs in order to maintain gainful employment.[79] To obtain this tax credit under IRC §21, the expenses must be for household services or for the care of a qualifying individual.[80] A "qualifying individual" is generally:

- A dependent under age 13, or
- The taxpayer's spouse or other dependent of any age who is mentally or physically impaired and who lived with the taxpayer for more than half of the year.[81]

An employee may exclude up to a maximum of $5,000 of dependent care assistance received from an employer under a qualified plan. This amount is reflected in box 10 of the employee's Form W-2 and reduces the allowable dependent care tax credit on Form 2441.

> **Note. Flexible spending accounts (FSAs)** are discussed later in this chapter. FSAs are most frequently used for the reimbursement of medical and dental expenses. However, a similar FSA arrangement may also be used for the reimbursement of dependent care expenses. **Although married spouses can each use a dependent care FSA, their combined contributions cannot exceed the $5,000 limit.**

"Dependent care assistance" is a payment made by an employer for services that would qualify for the household or dependent care tax credit under §21 if the employee had paid for those services directly. In order for the employee to benefit from the income exclusion, the dependent care assistance must be provided by a qualified dependent care assistance plan. A plan is qualified if it is **nondiscriminatory.** A nondiscriminatory plan is one that does not favor highly compensated employees in connection with benefits provided or the ability to participate in the plan.

> **Note.** The general nondiscrimination rules for a dependent care assistance plan are found in IRC §§129(d)(4) and 129(d)(8).

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76. Ibid.
77. IRC §132(f)(5)(F)(iii).
78. Treas. Reg. §1.132-9.
79. IRC §21.
80. IRC §21(b)(2)(A).
81. IRC §21(b)(1).

Group-Term Life Insurance Benefits

An employee **can exclude the cost of up to $50,000** of employer-provided group-term life insurance coverage on the employee's life.[82] An "employee" for purposes of this exclusionary rule is limited to a person presently working for an employer within a legal employer-employee relationship or a former employee that worked within a legal employer-employee relationship.[83] A full-time life insurance salesperson who is an employee for payroll tax withholding purposes is also included.[84] The fact that a taxpayer is a partner, shareholder, or director **does not make them an employee** for purposes of qualifying for this exclusion.

Group-term life insurance that qualifies for the exclusion is generally life insurance that:

- Provides a general death benefit that IRC §101(a) excludes from income,
- Is provided to a group of employees, and
- Is provided under a policy carried directly or indirectly by the employer.[85]

The cost of any group-term life insurance coverage in excess of $50,000 must be included in the employee's income. The amount includable in income is reduced by any amount the employee has paid for group-term coverage.[86] Amounts included in the employee's income are subject to FICA taxes.[87] The cost that is includable in the employee's income **is not based on the actual cost** of the policy for the amount of excess coverage. Instead, the income inclusion amount is calculated by reference to Treas. Reg. §1.79-3, Table I, which is reproduced below.

Treasury Regulation §1.79-3, Table I
Uniform Premiums for $1,000 of
Group-Term Life Insurance Protection

5-Year Age Bracket	Cost per $1,000 of Life Insurance per Month
Under 25	$0.05
25 to 29	0.06
30 to 34	0.08
35 to 39	0.09
40 to 44	0.10
45 to 49	0.15
50 to 54	0.23
55 to 59	0.43
60 to 64	0.66
65 to 69	1.27
70 and above	2.06

82. IRC §79(a).
83. Treas. Reg. §1.79-0.
84. As defined in IRC §7701(a)(20).
85. Treas. Reg. §1.79-1(a).
86. Treas. Reg. §1.79-3(a)(2).
87. IRC §3121(a)(2)(C).

Example 24. Hilda is 52 years old and is employed by MegaDiversified Industries Corp (MDIC). MDIC provided Hilda with group-term life insurance coverage of $200,000 for the duration of 2012. Under the terms of the group-term plan, Hilda pays $1.50 annually for each $1,000 of coverage and MDIC pays the rest of the cost. Hilda's taxable income inclusion is calculated as follows using Table I as a reference.

Cost of $200,000 of group-term life coverage under Table I ($200 × .23 × 12 months)	$552
Cost of $50,000 of coverage under Table I ($50 × .23 × 12 months)	(138)
Cost of coverage in excess of $50,000	$414

The amount that Hilda must include in her 2012 income is initially calculated as $414. However, this amount is reduced by the amount Hilda paid in the year for group-term coverage as follows.

Initial income inclusion for coverage in excess of $50,000	$414
Less: amount Hilda paid for group-term coverage in 2012 ($1.50 × 200)	(300)
Amount includable in Hilda's income for 2012	$114

The exclusionary rule for group-term life insurance plans applies to nondiscriminatory plans. A group-term plan is discriminatory if it favors key employees over others in connection with the ability to participate in the plan or the amount of plan benefits.[88] With a discriminatory plan, key employees must include in income the actual cost or the Table I cost of benefits, whichever is greater.[89]

> **Note.** Details on what constitutes a discriminatory plan, including the definition of a "key employee," are found in IRC §79(d) and Temp. Treas. Reg. §1.79-4T.

Sick Pay

Sick pay is defined as amounts paid under a **plan** to an employee due to temporary absence from work because of injury, disability, or sickness.

A sick pay plan is a regular system established by the employer under which sick pay is made available to some or all employees. A sick pay plan may be established by a formal written document, established longstanding practice, or a benefit that has otherwise been made known to employees through a bulletin board posting, pamphlet, or other means. Mere occasional benefits provided to particular workers in need are not enough to constitute a plan. The following items are not sick pay and therefore are not subject to employment taxes.

- Disability retirement benefits
- Worker's compensation payments and payments from similar programs
- Health or accident insurance payments not related to work absence
- Medical or hospitalization plan payments to cover medical expenses

Income and Payroll Taxes. If sick pay is paid by the employer, the sick pay is subject to federal income tax withholding and payroll taxes. The amount to be withheld is typically based on the employee's Form W-4, *Employee's Withholding Allowance Certificate*.

88. IRC §79(d)(2).

89. IRC §79(d)(1).

Sick pay may be paid to the employee by a **third-party agent** of the employer. A third party is an agent of the employer if that third party only administers the payments to employees without providing sick pay insurance. A third party that determines employee eligibility for such payments can be an agent of the employer. If the employer's third-party agent makes the payments, those payments are subject to federal tax **withholding** and payroll taxes. **These payments may also be subject to state tax.**

If the payments are made by a non-agent third party, the payments are not subject to federal income tax and payroll taxes. An insurance company that provides sick pay coverage and payments to employees is an example of a non-agent third-party payor. An employee, however, can voluntarily request to have federal income tax withheld by using Form W-4S, *Request for Federal Income Tax Withholding from Sick Pay*. The nonagent third party should begin to withhold the requested tax amount from all payments of sick pay made eight or more days after the receipt of the Form W-4S. Tax withholding on payments made prior to the eighth day of receipt is discretionary.

The following payments are not subject to federal tax withholding, regardless of who the payor is.

- Payments made to the employee's estate or survivor any time after the employee's death
- Payments arising from after-tax contributions made by the employee to a sick pay plan

W-2 Reporting. Sick pay can be combined with other wages and compensation for the employee on a single Form W-2. Sick pay can also be shown on a separate Form W-2.

For sick pay that is subject to federal income tax withholding and payroll taxes, the amount of sick pay is included on Form W-2 in boxes 1, 3, and 5. The amounts of federal, social security, and Medicare taxes withheld are shown in boxes 2, 4, and 6, respectively.

An employee receiving nontaxable payments from a plan that received after-tax contributions should have the amount of such payments indicated in box 12 (along with code "J") if those payments were paid by a third party.

The "third party sick pay" box within box 13 must be checked when the payments were made by a third party.

Flexible Spending Accounts (FSAs)

An FSA can be offered to employees either alone or as part of a more comprehensive cafeteria plan. Self-employed taxpayers cannot use an FSA. An FSA is most frequently used for medical and dental expenses but can also be used for dependent care costs and other limited purposes, such as parking or transit reimbursement.

Typically, an employee voluntarily contributes to the FSA through a salary reduction agreement. The contribution amount is determined at the beginning of each FSA plan year. The employer withholds the required amount each pay period and deposits that amount into the employee's respective FSA. The employee can change the amount at the beginning of a plan year or if employment or family status changes occur as specified by the terms of the plan. If the FSA plan so specifies, the employer may also make contributions for the employee.

Employee contributions to an FSA are not subject to federal income tax withholding or payroll taxes. The FSA plan must establish a ceiling on contribution amounts. This is done by specifying either a maximum dollar amount or maximum percentage of pay that can be contributed.

> **Note.** Beginning in 2013, the maximum amount that an employee can contribute to a medical FSA is $2,500 per plan year.

In order to be excluded from income, distributions from an FSA must be made only to reimburse the employee for **qualified medical expenses.** Qualified medical expenses are expenses that qualify for the medical and dental expense deduction. With a **medical FSA,** the employee may obtain **at any time during the year** expense reimbursement up to a maximum amount equal to the amount the employee contributes during the year. Accordingly, a medical FSA is **"prefunded."**

Example 25. Ryan elects to participate in an FSA which is offered as part of his employer's cafeteria plan. At the beginning of the plan year, which commences on January 1, 2012, he elects to contribute $2,400 through a salary reduction arrangement. His employer withholds $200 per month starting with Ryan's monthly paycheck for January.

On May 31, 2012, Ryan has extensive dental surgery costing $2,400, which is a qualified medical expense. The FSA can reimburse Ryan for the full amount of the dental surgery at the end of May or any later time during 2012 even though Ryan has not yet contributed the full $2,400 for the year.

Example 26. Use the same facts as **Example 25,** except instead of a medical FSA, Ryan elects **a dependent care FSA.**

On May 31, 2012, he has qualifying dependent care expenses. Because Ryan only contributed to the FSA for five months as of the end of May, he can only obtain reimbursement for up to $1,000 (5 months × $200) at that time. Dependent care FSAs are **not prefunded** like medical FSAs.

Note. Qualifying medical and dental expenses are discussed in IRS Pub. 502, *Medical and Dental Expenses.* Qualified dependent care expenses are discussed earlier in this chapter.

To substantiate the qualified expense for which reimbursement is appropriately made, the employee must provide to the employer:

- A written statement from a third party stating the nature and amount of the expense, and
- The employee's written statement indicating that no other reimbursement is being received for the expense from another plan or other coverage.

Note. The FSA can only make distributions for qualified medical expenses actually incurred. It cannot make distributions in advance of the expense or to cover projected expenses.

Beginning in 2011, expenses for nonprescription medications no longer qualify for FSA reimbursement. However, **nonprescription insulin** continues to constitute a qualified medical expense.

Under the terms of an FSA, the amounts contributed by the employee must be spent during the plan year or the amount is forfeited. The plan may offer a **2½-month grace period** after the plan year for the employee to use any remaining funds. Forfeited amounts remain within the overall FSA plan for all employees collectively and can be used to defray future administrative costs of the plan or allocated equally as taxable income among all employee participants.